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C O N F I D E N T I A L SECTION 01 OF 03 BAKU 000446

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SUBJECT: AZERBAIJANI FINANCE MINISTER ON EPC, CO-FINANCING,
UTILITY SECTOR REFORM AND GAS TO EUROPE

Classified By: AMBASSADOR ANNE E. DERSE PER REASONS 1.4 (B,D)

11. (C) SUMMARY: Ambassador Derse called on Finance Minister Sharifov April 14 to discuss next steps for the Economic Partnership Commission, including the creation of the Co-Financing Working Group and a proposed June DVC with A/S Sullivan. Sharifov said that upon receipt of the U.S. Proposal for a Co-Financing Working Group, the Government of Azerbaijan (GOAJ) would respond and organize its ministerial participation. Sharifov told the Ambassador that the Ministry of Finance is reviewing the terms of reference for the U.S. Treasury's budget advisor and may have additional duties for her to perform. Turning to budgetary issues, Sharifov stated that GOAJ plans to use the supplemental budget to fund the budget shortfall at government ministries and agencies that resulted from the January price increases. Sharifov said the January price increases were part of a broader GOAJ effort to reform utilities, including the domestic energy market, and outlined plans for further energy reforms and new power generation projects. Sharifov said that a transit agreement with Turkey is critical to Azerbaijan's future sales of gas to Europe; a sale without the transit agreement could set a precedent with Turkey and undervalue any future gas sales. During his recent trip to Hungary, Sharifov said he sent clear messages that Azerbaijan is interested in participating in the Nabucco gas line and would have 4.5 bcm available in 2012 for the pipeline. Sharifov told the Ambassador that Azerbaijan needs to take its own energy security concerns into account and that the country's domestic needs come first. END SUMMARY.

12. (C) Ambassador met with Finance Minister Sharifov April 14 to discuss Economic Partnership Commission (EPC) next steps, including the formation of the Co-Financing Working Group. USAID Country Coordinator and EconOff accompanied the Ambassador to the meeting. Sharifov briefed the Ambassador about his recent trip to Turkey for a meeting of the Economic Cooperation Organization meeting. The Ambassador told Sharifov that the first digital video conference (DVC) with EEB Assistant Secretary Sullivan to discuss EPC progress could happen in mid-June, depending upon Sullivan and Sharifov's schedules. Sharifov indicated that mid-June would be a good time and an opportunity to announce the creation of the Assistance Co-Financing Working Group.

13. (C) Regarding the Ambassador's inquiry on the status of the U.S. Treasury budget advisor and the position's updated terms of reference (TOR), Sharifov said that the Finance Ministry was still working on the TOR and would likely have additional areas it would like the budget advisor to cover. Sharifov added that he would expedite an answer to the Ambassador's December 2006 letter. Turning to the medium-term economic framework, Sharifov said that inflation was the largest challenge for the GOAJ. He stated that first

quarter inflation totaled 16.6 percent, with four to five percent attributable the January increase in tariffs. Sharifov said that the GOAJ would soon implement anti-inflation measures, including budget and fiscal discipline, capital account liberalization and hard currency liberalization. Sharifov cautioned that liberalization could lead to an increase in foreign exchange speculators being attracted to Azerbaijan, aggravating the economic situation. (COMMENT: In view of the important link between inflation and economic growth, it is encouraging that the GOAJ is beginning to recognize the growing inflationary pressures and its possible negative effects on the economy.)

CO-FINANCING WORKING GROUP

14. (C) The Ambassador raised the Co-Financing working Group, a key outcome from the EPC in February, and requested Sharifov's input on possible GOAJ members. Sharifov told the Ambassador that the Ministry of Finance had not yet received from the relevant ministries and agencies the co-financing budget estimates for implementation of AID projects. Sharifov said that the Finance Ministry needed to know how much the GOAJ's part of the co-financing would total and what kind of projects would be implemented. From the Ambassador, he requested USG views on the establishment of the working group, noting that it would not be a problem for the GOAJ to organize ministerial participation. Sharifov told the Ambassador that he would officially request by letter this week additional details regarding the working group, including U.S. leadership and a list of participants. Upon receipt of the U.S. response, Sharifov stated that he would organize the first official meeting of the working group.

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SUPPLEMENTAL BUDGET

15. (C) Sharifov told the Ambassador that the GOAJ would use the supplemental budget (planned for June) to increase budget allocations at government ministries and institutions to make up for the increase in prices and utility tariffs. The January increase in electricity, gas, water and gasoline prices has depleted the operating budgets at many ministries. Sharifov noted that the supplemental budget was not linked to the government's need for additional revenues and that the government was not going to "pour money" into the budget. Sharifov said that the GOAJ subsidized the utility bills of internally displaced persons, adding that the GOAJ was examining ways to "educate" IDPs in conserving and saving electricity and water.

16. (C) Sharifov stated that the increase in utility prices was an important step in the reform of the utility sector, especially the electricity sector. He admitted that the local population did not "accept" enthusiastically the price increases, but he noted that the amount of cars on the street remained the same despite the increases. Sharifov argued that the increase in prices would force Azerbaijan to use its natural resources more efficiently. He highlighted Iran's gas coupon system as an example of a bad policy. Sharifov stated that government ministries and offices needed to be more "thrifty" and not waste the government's money or resources.

ENERGY SECTOR REFORM

17. (C) Sharifov stressed the importance of the market dictating the price of electricity. He stated that power generation in Azerbaijan was now feasible and that with new tariffs the electricity distributors could make money. At an April 13 Cabinet of Ministers meeting, President Aliyev noted that GOAJ utility subsidies totaled more than USD 1.4 billion per year and that the economy needed to conserve more.

Sharifov briefed the Ambassador on the GOAJ's new electricity tariff system, highlighting the creation of a uniform tariff.

He said that the tariff increases "were inevitable" and not an "easy decision." He added that the President had the political will to take the tough step of increasing prices in order to develop a market basis for the sector.

¶8. (C) Sharifov also said that at the April 13 Cabinet meeting, President Aliyev stressed that the GOAJ needed to ensure energy security in power generation. Azerbaijan needs to provide sufficient domestic capacity to power the expanding economy. Sharifov detailed to the Ambassador the current energy generation projects, including the commissioning of five modular power units, the north power station, a 500 megawatt power plant in Sumgayit and the rehabilitation of the Mingeshevir power station. Sharifov said that a new power station would be built in Alibayramli as the current station consumed too much fuel oil.

¶9. (C) Sharifov stated that Azerbaijan was interested in attracting independent power generators to Azerbaijan to supplement domestic generators, noting that several Asian companies have already expressed interest. He stated that to facilitate direct foreign investment, however, the GOAJ would need to pass a new law on electricity regulation to create the legal grounds to finalize reform. The Ministry of Finance is already working on a draft power and electricity sector reform law which will cover the following areas: power generation, high voltage infrastructure and distribution. The GOAJ would like to create a stand-alone power distributor that would be independent from the power grid. Sharifov stated that the private power stations would be able to sell their electricity to the state-owned power distributor, thus creating a market benchmark and maximizing power distribution and usage.

¶10. (C) Sharifov outlined to the Ambassador the problems with the current utility system, noting the "no payment" cycle that flows from customers to distributors to generators to the State Oil Company to the Ministry of Taxes and finally to the budget. Non-payment of utility bills, according to Sharifov, decreases revenues to the state budget. Reforming the sector, including providing customers with pre-payment electricity cards to avoid the problem of irregularities in metering and payments, would help eliminate payment delinquencies. Sharifov recognized that the GOAJ needed to provide citizens and businesses with reliable public services but underscored that these services could not be "free."

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¶11. (C) Upgrading current energy infrastructure is critical, according to Sharifov. Upgrading transmission lines and power substations and increasing collection efforts could save the GOAJ more than USD 200 million in lost kilowatt hours. The GOAJ also needs to change the mentality of users and the collectors with the goal of instilling a new culture of conservation and maximizing of natural resources. Sharifov noted that after the increase in prices in January, electricity usage dropped by more than six percent, adding that it was good the population was saving electricity.

GLOBAL ENERGY ISSUES

¶12. (C) Sharifov told the Ambassador that obtaining a transit agreement with Turkey was critical to Azerbaijan's future sales of gas to Europe and now was the time to put momentum into the effort. He said that Ambassador Aleskerov, the new GOAJ energy ambassador, would take the lead in negotiating the transit agreement with Turkey. Sharifov said that Turkey and Azerbaijan need to start talking. Sharifov said that the GOAJ should not rush to sell gas to Greece without a transit agreement with Turkey. Sharifov is concerned that a sale without the transit agreement could set a precedent with Turkey that Azerbaijani gas could be sold in other ways than

transit and possibly undervalue any future gas sales. Sharifov highlighted that Turkey wants to resell gas and that it has a relationship with Gazprom. Sharifov stressed that the GOAJ does not want to spoil any long-term strategic energy sales by tactically rushing to sell gas to Greece.

¶13. (C) Sharifov stated that during his recent trip to Hungary, he sent clear messages that Azerbaijan is interested in participating in the Nabucco gas pipeline. In addition, Sharifov stated that SOCAR has told OMV that it will have 4.5 bcm available in 2012 for the pipeline. Sharifov stated that Azerbaijan needs to allocate gas for Europe and that a trans-Caspian pipeline with Kazakh and Turkmen would also increase the amount of gas available to Europe.

¶14. (C) Sharifov told the Ambassador that Azerbaijan needs to take its own energy security concerns into account and that the country's domestic needs come first. He stated that Azerbaijan plans to build from scratch a new petrochemical industry, to replace Azerkimia, and that based on the almost completed feasibility study done by a U.S. company, the petrochemical plant would pay the same price for the gas as Europe, but without any of the side costs, such as transit fees. (NOTE: The feasibility study for the new plant is scheduled to be released in early May. The Azerbaijani Investment Company is a major shareholder in the project. The total project is reportedly worth more than USD 1 billion). The petrochemical plant in the first stage would consume 1.2 bcm per year and would eventually consume 2.2 bcm. To support his argument that Azerbaijan needed to keep more of its gas, Sharifov reiterated to the Ambassador that a strong domestic economic situation in Azerbaijan would translate into a strong U.S. partner in the region.

COMMENT

¶15. (C) Sharifov's comments regarding the government's planned anti-inflationary measures is a welcome step towards focusing on a growing economic issue and may translate into more disciplined fiscal and monetary policies in the future. Sharifov's description of overall reform in the utility sector, especially in electricity distribution and generation, is important in enabling market forces to set correct prices in support of the growing economy. The GOAJ's willingness to proceed with co-financing of assistance and seeking USG advice and thoughts on co-financing next steps demonstrates the growing political will to develop this new option for sustainable economic development. Sharifov's commitment to advance talks with Turkey on a gas transit agreement is good news and Embassy will monitor the discussions closely.
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